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10.0 AT-RISK LIMITATIONS

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10.1 GENERAL OVERVIEW – IRC §465, R&TC §17551, AND §24691

A shareholder's ability to deduct losses passing through to the shareholder from an S-Corporation is limited in two ways.

First, the shareholder can only deduct losses to the extent that the shareholder has a sufficient basis in the stock and debt of the S-Corporation. (IRC §1366(d)(1))

Second, the shareholder can only deduct losses to the extent that the shareholder has a sufficient amount at-risk with regard to the shareholder's investment in the S-Corporation. (IRC §465)

Common parlance has used the term "at-risk" to refer to both of these limitations on the deduction of S-Corporation losses, but the term "at-risk" technically applies only to the latter limitation. Oftentimes a shareholder's stock and debt bases will be the same as the shareholder's amount at-risk; however, the shareholder's amount at-risk can be lower than the shareholder's stock and debt bases due to the fact that some transactions that give rise to additional basis do not provide an addition to the shareholder's amount at risk. (IRC §465(b)(3) and (4))

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10.2 AMOUNT AT-RISK

An S-Corporation shareholder is considered at risk for the sum of the following (IRC §465(b)(1)):

- The amount of money and the adjusted basis of other property contributed by the shareholder to the activity; and
- Amounts borrowed with respect to such activity (as determined under IRC §465(b)(2)).

An S-Corporation shareholder's amount at-risk, as determined above, must be increased and decreased by the S-Corporation's items of income, deduction, and loss, and distributions, having an affect on the shareholder's basis in the S-Corporation.

However, the items described in IRC §465(b)(3) and (4) must be disregarded in making the adjustments. (Temporary Reg. §7.465-2(b))

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10.3 CONTRIBUTIONS OF CASH OR OTHER PROPERTY

IRC §465(b)(1)(A) provides that the taxpayer, including a shareholder of an S-Corporation, is at- risk for an activity with respect to the amount of money and the adjusted basis of "other property" contributed by the taxpayer to the activity. Proposed Reg. §1.465-22(a) elaborates by providing that a taxpayer's amount at-risk in an activity will be increased by the "personal funds" the taxpayer contributes to the activity. Proposed Reg. §1.465-9(f) provides that "personal funds" means funds that satisfy all of the following conditions:

- They are owned by the taxpayer;
- They are not acquired through borrowing; and
- They have a basis equal to their fair market value.

Personal funds do not necessarily include amounts an S-Corporation shareholder borrows and then contributes or lends to the S-Corporation. An S-Corporation shareholder is only considered at-risk with respect to borrowed funds if the S-Corporation shareholder is personally liable for the repayment of the borrowed funds or has pledged property, other than property used by the S-Corporation, as security for the borrowed funds. (IRC §465(b)(2))

IRC §465(b)(1)(A) provides the general rule that a taxpayer's at-risk amount is increased by the adjusted basis of property, other than money, contributed to the activity. However, where an S-Corporation shareholder contributes unencumbered property to an S-Corporation that was purchased with borrowed funds, the S-Corporation shareholder's amount at-risk is only increased to the extent that the S-Corporation shareholder is personally liable for, or has pledged property to secure, repayment of the borrowed funds. (Reg. §1.465-20(a) and Proposed Reg. §1.465-23(a))

Proposed Reg. §1.465-23(a)(2) sets forth rules for determining the increase in a taxpayer's at-risk amount where the taxpayer contributes encumbered property to an activity. Where a taxpayer contributes property subject to liabilities for which the taxpayer is personally liable (recourse liabilities), the taxpayer's at-risk amount is increased by the adjusted basis of the contributed property just as if the contributed property were unencumbered. (Proposed Reg. §1.465-23(a)(2)) Where the contributed property is subject

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to a nonrecourse liability, the taxpayer's amount at-risk is increased by the taxpayer's adjusted basis in such property and then the taxpayer's amount at-risk is decreased by the amount of the nonrecourse liability. (Proposed Reg. §1.465-23(a)(2)(ii)) For purposes of determining the increase in the taxpayer's at-risk amount caused by property contributions, Proposed Reg. §1.465-23(b)(1) requires use of the adjusted basis of the contributed property that would have been used in determining the loss if the contributed property were sold immediately after being contributed to the activity.

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10.4 CONTRIBUTIONS OF CASH OR OTHER PROPERTY PURCHASED WITH BORROWED FUNDS

As mentioned above, where an S-Corporation shareholder contributes or loans borrowed money to an S-Corporation or contributes unencumbered property purchased with borrowed funds, the shareholder's at-risk amount will increase only to the extent such shareholder is at-risk with respect to such borrowed amount. IRC §465(b)(1)(B) provides that a taxpayer will be at-risk with respect to amounts borrowed for use in an activity to the extent provided in IRC §465(b)(2). This section sets forth rules for determining a taxpayer's at-risk amount for borrowed funds, depending on whether the loan is recourse or nonrecourse.

10.4.1 Recourse Financing

A taxpayer is at-risk with respect to amounts borrowed for use in an activity to the extent personally liable for repayment of the loan. (IRC §465(b)(2)(A)) Thus, where an S-Corporation shareholder borrows funds on a recourse basis, such shareholder generally will be at-risk for the loan proceeds thereafter actually contributed or loaned to the S-Corporation.

10.4.2 Non-recourse Financing

In the case of amounts borrowed on a nonrecourse basis for use in an activity, the taxpayer will be at-risk where the taxpayer has pledged property, other than property used in such activity, as security for the amounts borrowed to the extent of the "net fair market value" of the taxpayer's interest in the pledged property. (IRC §465(b)(2)(B))
For this purpose, a shareholder's stock in the S-Corporation conducting the activity for which the funds are borrowed is property used in the activity. (See the last sentence of IRC §465(b)(2) and Proposed Reg. §1.465-

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25(b)(1), which applies this rule to partnerships.) Thus, an S-Corporation shareholder is not at-risk for amounts contributed or loaned to an S-Corporation obtained through a nonrecourse loan secured only by the shareholder's S-Corporation stock.

Example A

Sam and Joel form an S-Corporation.

Sam contributes $100,000 of his personal funds in exchange for 50% of the stock.

Joel borrows $100,000 on a nonrecourse basis secured only by a pledge of the S-Corporation stock. Joel contributes the $100,000 in exchange for 50% of the stock.

Sam's shareholder basis at the beginning of Year 1 is $100,000 and his at-risk-basis, $100,000.

Joel's shareholder basis at the beginning of Year 1 is $100,000 and his at-risk basis, $0.

Assuming the S-Corporation reported an ordinary loss of ($150,000), Sam and Joel would report the following:

	Sam Recognized	Joel Recognized	Joel Suspended
1st Loss Limitation Level – Shareholder Basis			
Beginning stock basis	$100,000	$100,000	
Ordinary loss	-75,000	-75,000	
Ending stock basis	25,000	25,000	
2nd Loss Limitation Level – At-Risk			
Beginning at-risk basis	$100,000	$ 0	
Ordinary loss	-75,000	0	-$75,000
Ending at-risk basis	$ 25,000	$ 0	

Sam is allowed to recognize ($75,000) ordinary loss after application of the

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shareholder basis and at-risk limitations.

Joel is allowed to recognize $75,000 ordinary loss after application of the shareholder basis, but cannot recognize any of the loss at the at-risk level.

10.4.3 Qualified Nonrecourse Financing

Although an S-Corporation shareholder will generally not be at-risk for amounts contributed or loaned to the corporation obtained through nonrecourse financing secured only by property used in the activity, a limited exception is available under IRC §465(b)(6) for "qualified nonrecourse financing."

Under this rule, a taxpayer is at-risk with respect to qualified nonrecourse financing that is secured by real property used in the activity of holding real property. IRC §465(b)(6)(B) provides that qualified nonrecourse financing is financing:

- Borrowed by the taxpayer with respect to the activity of holding real property.
- Borrowed by the taxpayer from a "qualified person" (or from a federal, state, or local government or instrumentality thereof, or guaranteed by such an entity).
- With respect to which no person is personally liable for repayment.
- That is not convertible debt.

A "qualified person" is a person who is actively and regularly engaged in the business of lending money and not:

- A related person with respect to the taxpayer, except where the financing from such related person is commercially reasonable and on substantially the same terms as loans involving unrelated persons.
- A person from whom the taxpayer acquired the property (or a related person to such person).
- A person who receives a fee with respect to the taxpayer's investment in the property (or a related person to such person). (IRC §§49(a)(1)(D)(iv) and 465(b)(6)(D))

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Thus, a taxpayer is at-risk for amounts borrowed on a nonrecourse basis that are secured by and used in the activity of holding real property if the loan is made by a person actively and regularly engaged in the business of lending money (including related persons, where the financing is commercially reasonable and on substantially the same terms as loans involving unrelated persons).

In the S-Corporation context, this provision will have limited applicability since shareholders of an S-Corporation generally are not permitted to increase their stock or debt basis by corporate-level indebtedness. Generally, IRC §1366(d)(1) will prevent the S-Corporation shareholder from deducting losses, even though nonrecourse financing may permit the S-Corporation shareholder to satisfy the at-risk limitation.

Where, however, qualified nonrecourse financing is structured as a "back-to-back" loan or capital contribution between the shareholder (as the primary debtor to the qualified lender) and the S-Corporation; the shareholder should be able to take advantage of this provision. Thus, if an S-Corporation shareholder borrows money on a nonrecourse basis from a qualified lender secured only by real property used by the S-Corporation in real property activities, and the shareholder thereafter contributes or loans such funds to the S-Corporation, such shareholder's at-risk amount and basis amount will be increased by the loan proceeds contributed or loaned to the S-Corporation. In Example A at section 10.4, if the S-Corporation used the capital contributions made to it to purchase real property to be used in the activity of holding real property, and Joel had obtained his loan from a qualified lender and secured such loan by the S-Corporation's real property rather than by a pledge of his S-Corporation stock, Joel's at-risk amount would increase to $100,000, the same as his basis in his S-Corporation stock.

Proposed Reg. §1.465-25(a)(4) provides that the net FMV of property pledged as security is the excess of the property's FMV as of the date it is pledged over the total superior liens to which such property is subject. Subsequent changes in the property's FMV are not taken into account for purposes of determining net FMV; however, to the extent the amount of superior liens changes during the taxable year, the net FMV is adjusted as of the close of such taxable year.

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To the extent the superior liens to which pledged property is subject to increase during the taxable year, the taxpayer's at-risk amount will be decreased. (Proposed Reg. §1.465-25(a)(4)) To the extent the amount of such superior liens decreases during the taxable year, the taxpayer's at-risk amount will increase. (Proposed Reg. §1.465-25(a)(4)) Additionally, where property used outside the activity has been pledged as security for a nonrecourse loan, and the taxpayer subsequently contributes the pledged property to the activity, the net FMV of the pledged property is reduced to zero (which will reduce the taxpayer's at-risk amount in the activity), and the taxpayer will be considered to have contributed unencumbered property to the activity (which will increase the taxpayer's at-risk amount by the adjusted basis of the pledged property). (Proposed Reg. §1.465-25(a)(3))

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10.5 AMOUNTS BORROWED FROM PERSONS HAVING AN INTEREST IN THE ACTIVITY

An S-Corporation shareholder is generally not at-risk with regard to funds borrowed from a person who has an interest in the S-Corporation or a person related to a person having an interest in the S-Corporation. (IRC §465(b)(3)(A))

However, if the lender's interest in the S-Corporation is only an interest as a creditor, the S-Corporation shareholder will be considered at-risk with regard to the borrowed funds. (IRC §465(b)(3)(B)(i)) Therefore, an S-Corporation shareholder will not be considered at-risk with regard to funds borrowed from other shareholders because the other shareholders have an interest in the S-Corporation that is not merely an interest as a creditor.

Reg. §1.465-8 sets forth rules for determining when a person has an interest in an activity other than as a creditor. In the case of recourse loans, Reg. §1.465-8(b)(1) provides that the lender will have an interest in the activity other than as a creditor if the lender has either a capital interest in the activity (a shareholder of the S-Corporation) or an interest in the net profits of the activity. Under Reg. §1.465-8(b)(2), a capital interest in an activity is an interest in the assets of the activity that is distributable to the owner of the interest upon liquidation of the activity. Thus, an S-Corporation shareholder has a capital interest in the activities conducted by the S-Corporation. Reg. §1.465-8(b)(3) provides that a person has an interest in the net profits of an S-Corporation if any part of the person's compensation is determined with regard to the net profits of the S-Corporation (i.e. employees and independent contractors), regardless of whether such person holds any of the incidents of ownership with respect to the S-Corporation.

In the case of nonrecourse loans secured by assets having a readily ascertainable FMV, the lender will be a person with an interest in the activity other than as a creditor only if the lender has either a capital interest in the activity or an interest in the net profits of the activity. (Reg. §1.465-8(c)(1)) An interest in the gross receipts of an S-Corporation is not a net profits interest for this purpose. (Reg. §1.465-8(b)(4), Example (2))

In the case of nonrecourse loans secured by assets not having a readily ascertainable FMV, however, the lender will be a person with an interest in

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the activity other than as a creditor if the lender stands to receive financial gain (1) other than interest from the activity (i.e. - compensation for services rendered in connection with the organization or operation of the activity) or (2) from the sale of an interest in the activity. (Reg. §1.465-8(d)(1))

Thus, a promoter who organizes the activity or solicits potential investors in the activity will generally have an interest in the activity other than as a creditor with respect to nonrecourse loans secured only by property not having a readily ascertainable FMV.

10.5.1 Limited Application

10.5.1 Limited Application

Although the previous section discussed the related party rules contained in IRC §465(b)(3) as if they applied to all S-Corporation shareholders, these rules do not automatically apply to S-Corporation shareholders. The related party rules contained in IRC §465(b)(3) only apply to S-Corporation shareholders to the extent the S-Corporation is involved in the following five activities listed in IRC §465(c)(1):

- Holding, producing, or distributing motion picture films or videotapes;
- Farming (as defined in IRC §464(e));
- Leasing any IRC §1245 property (as defined in IRC §1245(a)(3));
- Exploring for, or exploiting, oil and gas resources as a trade or business or for the production of income; or
- Exploring for, or exploiting, geothermal deposits (as defined in IRC §613(e)(2)).

The reason for this limitation is statutory. When IRC §465 was originally enacted in 1976, it only applied to the five activities listed above. (See P.L. 94-455.) IRC §465(c)(3) was added to the Code in 1978 and thereby extended the application of IRC §465 to include activities engaged in by the taxpayer in carrying on a trade or business or for the production of income, which would include investments in an S-Corporation. (See P.L. 95-600.)

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However, when Congress enacted IRC §465(c)(3), Congress limited the application of the related party rules to these newly covered activities by enacting IRC §465(c)(3)(D), which provides that the related party rules will only apply to the new activities to the extent provided by the regulations. Unfortunately, the Treasury has never promulgated the regulation required by Congress and in 1990 the Tax Court held that the related party rules could not be applied to the newly covered activities until the IRS promulgates such regulations. (See Alexander v. Commissioner (1990) 95 T.C. 467.)

If an auditor encounters a situation where an S-Corporation shareholder would not be entitled to increase his or her at-risk amount if the related party rules of IRC §465(b)(3) were applied, but the rules cannot be applied due to the fact that the S-Corporation is not involved in one of the five activities discussed above, the auditor should review the transaction with regard to IRC §465(b)(4). Under IRC §465(b)(4), "a taxpayer shall not be considered at risk with respect to amounts protected against loss through nonrecourse financing, guarantees, stop loss agreements, or other similar arrangements."

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10.6 CORPORATE-LEVEL INDEBTEDNESS

As mentioned above, S-Corporation shareholders generally are not permitted to increase their at-risk amount for their share of corporate-level indebtedness representing loans from third parties or from other shareholders of the S-Corporation. It is important to distinguish differences between at-risk basis of the S-Corporation separate from the at-risk basis of the shareholder.

In general, S-Corporations determine their amount at-risk in the same manner as any other taxpayer. (Proposed Reg. §1.465-10(b)(1)) However, where the S-Corporation borrows funds from its own shareholders for use in an activity governed by IRC §465, the borrowed funds will increase the S-Corporation's amount at-risk, despite the fact that the shareholders have an interest in the S-Corporation's activities that is not merely an interest as a creditor. (Proposed Reg. §1.465-10(b)(2))

Pursuant to Proposed Reg. §1.465-6(d), an S-Corporation shareholder's personally guarantee for a loan made directly to the S-Corporation does not increase the S-Corporation shareholder's amount at-risk. However, if the S-Corporation shareholder actually repays all or a part of the debt, the S-Corporation shareholder will be entitled to increase his or her amount at-risk by the amount of the payments when the S-Corporation shareholder no longer has a legal right to seek indemnification from the primary obligor on the loan (i.e. the S-Corporation or another shareholder). (Proposed Reg. §1.465-6(d))

An S-Corporation shareholder can increase his or her amount at-risk with regard to the S-Corporation for what otherwise might appear to be corporate indebtedness if, under the terms of the loan agreement:

- The S-Corporation shareholder is the primary obligor on the loan,
- The loan is made directly to the S-Corporation shareholder, and
- The S-Corporation shareholder contributes or loans the borrowed funds to the S-Corporation. (Proposed Reg. §1.465-10(d))

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10.7 PURCHASE OF STOCK

Under Proposed Reg. §1.465-22(d), the amount paid by a purchaser for an interest in an activity, such as stock in an S-Corporation, is treated as a contribution to the activity. Thus, where an S-Corporation shareholder purchases stock from an existing shareholder, the purchasing shareholder will be at-risk to the extent the purchase price (contribution) would increase the shareholder's at-risk amount. For example, if the stock were paid for in cash from the purchasing shareholder's personal funds, the at-risk amount would equal the purchase price of the stock. However, if the stock purchase were financed through a nonrecourse loan secured only by a pledge of the purchased stock, the purchasing shareholder's initial at-risk amount would be zero. (Proposed Reg. §1.465-25(b)) The rules for determining whether other property constitutes an interest in the activity are contained in Reg. §1.465-8.

10.7.1 Conversion from C to S-Corporation Status

When a C corporation converts to an S-Corporation status, the shareholder's initial amount at-risk will be the shareholders adjusted basis in the corporation, determined by disregarding amounts described in IRC §465(b)(3) and (4). Presumably, a shareholder's adjusted cost basis in stock and loans made by such shareholder to the corporation as of the date of the conversion would be amounts at-risk for such shareholder. (Reg. §7.465-2(a) and Proposed Reg. §1.465-76(a))

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10.8 ADJUSTMENTS TO AT-RISK AMOUNT

An S-Corporation shareholder's pro rata share of the S-Corporation's items of income, including tax-exempt income, will increase the shareholder's at-risk amount. (Proposed Reg. §1.465-22(c)) In addition, gain recognized on the disposition of an activity or an interest in an activity will be treated as income from such activity. (Proposed Reg. §§1.465-12(a) and 1.465-66(a)) Also, a shareholder's at-risk amount will be increased by additional capital contributions of cash and property and for loans made by the shareholder to the S-Corporation, subject to the exceptions contained in IRC §465(b), (IRC §465(b)(1) and Proposed Reg. §1.465-10(c)) However, where there is an increase in a shareholder's at-risk amount immediately prior to the end of the S-Corporation's taxable year, which is followed by a corresponding decrease in such shareholder's at-risk amount shortly thereafter in the succeeding taxable year, such increase would be ignored under the proposed regulations except in limited circumstances. (Proposed Reg. §1.465-4(a))

A shareholder's pro rata share of an S-Corporation's items of loss or deduction, including nondeductible expenses not properly chargeable to a capital account, will decrease the shareholder's at-risk amount, but only to the extent the loss or deduction would be allowed to the taxpayer under IRC §465(a). (Proposed Reg. §1.465-22(c)(2)) Also, an S-Corporation shareholder's at-risk amount will be reduced by distributions of money, whether in the form of a distribution made with respect to stock (out of the shareholder's stock basis or out of the accumulated adjustments account) or in the form of a loan repayment, to the extent of any decrease in the shareholder's adjusted basis in such indebtedness. (Proposed Reg. §1.465-22(b))

An S-Corporation's distribution of property other than money to a shareholder will decrease the shareholder's at-risk amounts in the activity in which the property was used. The decrease will equal the property's adjusted basis less any liabilities to which the property is subject for which the shareholder is not personally liable. The subsequent repayment of such liability by the taxpayer following the distribution will not increase the taxpayer's at-risk amount. (Proposed Reg. §1.465-23(c))

Where an S-Corporation shareholder has incurred recourse indebtedness and contributed or loaned the borrowed funds to his or her S-Corporation,

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Proposed Reg. §1.465-24(b) provides rules for determining the effect of the shareholder's loan repayments to the creditor on the taxpayer's at-risk amount. In general, loan repayments on a recourse loan will not increase the shareholder's amount at-risk. However, there are two situations where the repayments will decrease the shareholder's at-risk amount. First, where the S-Corporation shareholder uses assets that are already used in the activity, such as stock in the S-Corporation, to repay the recourse indebtedness, the S-Corporation shareholder's amount at-risk will decrease by the adjusted basis of the assets (as defined in Proposed Reg. §1.465-23(b)(1)). (See Proposed Reg. §1.465-24(b)(2).) Second, where the S-Corporation shareholder uses funds, which would not increase the S-Corporation shareholder's at-risk amount if contributed directly to the S-Corporation, to repay the recourse indebtedness, the S-Corporation shareholder's amount at-risk will be decreased by the amount of such funds. For example, where an S-Corporation shareholder repays a recourse loan with the proceeds of a nonrecourse loan secured by the S-Corporation shareholder's interest in the S-Corporation, the S-Corporation shareholder's amount at-risk will be decreased by the amount of the repayment. Where an S-Corporation shareholder has incurred nonrecourse indebtedness and contributed or loaned the borrowed funds to his or her S-Corporation, Proposed Reg. §1.465-25(b)(2) provides rules for determining the effect of loan repayments.

In the case of nonrecourse loans, repayments may either increase or decrease the S-Corporation shareholder's amount at-risk depending upon two factors.

- The first factor is whether the nonrecourse loan increased the S-Corporation's shareholder's at-risk amount at the time it was incurred.
- The second factor is whether the funds or property used to make the repayment would increase the S-Corporation shareholder's amount at-risk if the funds or property were contributed directly to the S-Corporation.

If the S-Corporation shareholder's nonrecourse loan did not increase the S-Corporation shareholder's amount at-risk at the time it was incurred, subsequent repayments of the loan will result in an increase in the S-Corporation shareholder's amount at-risk. (Proposed Reg. §1.465-25(b)(2)(i)) However, if the amounts used to repay the nonrecourse

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indebtedness would not have increased the S-Corporation shareholder's amount at-risk if contributed directly to the S-Corporation, the S-Corporation shareholder's amount at-risk is unaffected by the repayment.
If the S-Corporation shareholder's nonrecourse loan did increase the S-Corporation shareholder's amount at-risk at the time it was incurred, subsequent repayments will not increase the S-Corporation shareholder's amount at-risk. However, if the amount used to repay this type of nonrecourse loan would not increase the S-Corporation shareholder's at-risk amount if contributed directly to the S-Corporation, the repayment will actually decrease the S-Corporation shareholder's at-risk amount.

If an S-Corporation shareholder's nonrecourse loan is converted to recourse, the S-Corporation shareholder's amount at-risk must be adjusted for the rules applicable to recourse indebtedness.

If an S-Corporation shareholder's recourse loan is converted to a nonrecourse loan, the S-Corporation shareholder's amount at-risk must be adjusted for the rules applicable to nonrecourse indebtedness. However, there are special rules for recourse loans, which become nonrecourse upon the happening of an event or a lapse of time (i.e. contingencies). Under such circumstances, the S-Corporation shareholder is only considered at-risk with regard to the loan while it was recourse if:

- There was a business purpose for incurring such indebtedness (determined by applying all of the facts and circumstances);
- The primary motivation for incurring the indebtedness was not the income tax consequences (also determined by applying all of the facts and circumstances); and
- The loan agreement is consistent with the normal commercial practice for financing the activity for which the money is being borrowed. (Proposed Reg. §1.465-5)

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10.9 MULTIPLE ACTIVITIES - SEPARATELY COMPUTED & AGGREGATION RULES

10.9.1 Separate Computation

When an S-Corporation is engaged in multiple activities described in IRC §465(c)(1) and (3), the S-Corporation shareholder's at-risk amount must be separately computed for each activity. (IRC §§ 465(c)(2) and 465(c)(3)(B))

10.9.2 Aggregation Rules

In general, a taxpayer's activity with respect to each film or videotape, leased IRC §1245 property, farm, oil or gas property, or geothermal property is a separate activity. (IRC §465(c)(2)(A)) However, under IRC §465(c)(2)(B)(i), all activities with respect to IRC §1245 property that are leased or held for lease and placed in service in a particular taxable year of an S-Corporation may be aggregated as a single activity. In addition, Temporary Reg. §1.465-1T permits S-Corporation shareholder's and S-Corporation's themselves to aggregate activities within each of the other four enumerated categories (motion picture film and videotape activities, farming activities, oil and gas activities, and geothermal activities) as a single activity if more than one activity within a single category are engaged in by the S-Corporation. However, except, as discussed below, different categories of activities within the five enumerated categories may not be aggregated as a single activity.

Under IRC §465(c)(3)(B), activities (other than the five enumerated IRC §465(c)(1) activities) that constitute a trade or business will be a single activity if the taxpayer actively participates in the management of such trade or business, or such trade or business is carried on by an S-Corporation and 65% or more of the losses for the taxable year are allocable to persons who actively participate in its management.

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Thus, S-Corporation shareholder's who actively participate in the S-Corporation's activities can always aggregate all of the activities that constitute a trade or business, and S-Corporation shareholders who do not actively participate in the S-Corporation's activities will still be able to aggregate such activities so long as the other shareholders satisfy the second test described above.

Active participation in management depends upon the facts and circumstances of each situation.

Factors that tend to indicate active participation include;

- participating in the decisions involving the operation or management of the trade or business,
- actually performing services for the trade or business, or
- hiring and discharging employees (as compared to only the person who is in charge of the trade or business)." (See H.R.Rep. No. 95-1445, 2d Sess., pp. 69 and 70 (1978).)

Factors that tend to indicate a lack of active participation include;

- lack of control of management and operations of the trade or business,
- having authority only to discharge the manager of the trade or business, and
- having a manager of the trade or business who is an independent contractor rather than an employee." (See H.R.Rep. No. 95-1445, 2d Sess., pp. 69 and 70 (1978).) Thus, the sole action of hiring an independent contractor as the manager of an activity will not constitute active participation in the management of a trade or business.

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10.10 DISPOSITION OF STOCK

An S-Corporation shareholder who has suspended deductions, because of either an insufficient at-risk amount under IRC §465(a)(2) or the loss recapture rules under IRC §465(e), may be able to use such deductions upon the sale or other disposition of S-Corporation stock.

See Proposed Reg. §1.465-12(a) and Proposed Reg. §1.465-66(a) for the rules applicable to determining when gain on the sale of an activity or an interest in the activity will be treated as income from the activity.

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